Irish Life

INVESTMENT OUTLOOK 2019

Equity Outlook

2018 proved to a very volatile and disappointing year for global equity markets. Despite hitting new all time highs in late September, global equities experienced sharp declines in the fourth quarter, mainly due to rising concerns over the global growth outlook. These concerns were exacerbated by fears that continued tightening of US monetary policy by the Fed could contribute to a significant US slowdown or even recession in 2019. For the year global equities declined -7.2% in local currency terms or -4.3% in Euro terms.

Looking forward to 2019, while global growth has probably peaked and is expected to slow compared to 2018, growth nevertheless is still anticipated to remain positive with both the US and global economies expected to avoid a recession. Leading indicators such as global Purchasing Managers Indices (PMI's) have fallen but are at levels consistent with global growth of 2.8%, still a healthy level and above that experienced in most years since the financial crisis with the recent exception of 2017 and 2018 when growth rebounded to over 3%.

While risks to growth do remain, our sense is that these can be overcome in 2019. Concerns linger over the risk to growth associated with trade issues. Following a number of compromises through the summer including the agreement of a new NAFTA trade agreement between the US, Mexico and Canada we believe the tail risks to global growth from the potential outbreak of a global trade war have been significantly reduced. The recent announcement of a truce in the trade dispute between the US and China has also raised the possibility of a compromise being reached between the world's two largest economies which would significantly reduce the uncertainty which has acted as a drag on sentiment, investment and activity in both countries. Comments from officials on both sides have been cautiously optimistic that an agreement can ultimately be reached.

In terms of the risk posed by higher interest rates and increased tightening of monetary policies, we believe the recent concerns over growth and tightening of financial conditions will result in a much slower pace of policy restraint through 2019. The US Fed has already reduced its forecast for the number of rate rises in 2019 to two from three previously with an increasing likelihood that the Fed could announce at least a temporary pause to further interest rate rises if its actions were perceived as posing a risk to growth. Increased levels of fiscal stimulus across various regions in 2019 should also provide support to the economic backdrop. Other potential risks however such as political issues around Brexit, European politics in general and the policy agenda of the US administration are also acting as headwinds for markets and are likely to result in volatility remaining elevated in 2019 as various ongoing uncertainties continue to act as headwinds for markets.

Following the recent falls in markets, equities now appear to be discounting the risks to growth with valuations having reset lower to below long term averages. Global equities are currently trading on a 12 month forward P/e multiple of 13.0x versus a long term average of 15.6x while equities are also now trading below long term averages on a dividend yield and price to book basis.

To generate positive returns in 2019 equities need to see evidence of global growth and earnings showing signs of stabilisation in coming months. Without this, equities could continue to struggle and see further declines of up to 10% despite the recent falls. Given current valuation levels, the potential for less aggressive policy tightening by central banks, increased levels of fiscal stimulus and the continuation of positive economic and earnings growth, equities can see a return to gains in the coming year if these factors become more apparent through 2019. Our base case is that global equity markets can rise between 5/8% in 2019 and that the trough in December will prove to be the low for markets. Risks around this however remain high with the large number of unresolved issues probably meaning volatility remains a feature, resulting in a wide range of potential outcomes for the year.

Bond utlook

Having generally trended higher since the lows evident in mid 2016, global bond yields began to move lower again in late 2018 as renewed concerns emerged about global growth and the persistence of low levels of inflation.

The recent fall in yields already appear to be discounting slower growth, lower inflation and less monetary policy tightening in 2019. The potential range in which yields are likely to trade through 2019 however remains wide and is sensitive to the ultimate economic backdrop. Continued deterioration in global growth would lead to lower yields while a stabilisation of global growth close to 3% would probably result in higher yields.

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The US 10 year yield is currently 2.63% compared to a recent high of 3.25%. The potential trading range in 2019 could be 1.75%/3.50% and our base case is that yields will be close to 3% by year end on the assumption that growth remains reasonably strong and a recession is avoided. The German 10 year yield is currently 0.16% compared to a 2018 high of 0.77%. The potential range through the year is seen as -0.10%/0.80% with a base case of 0.50% at year end, again on the assumption that growth remains positive and a worst case scenario of a recession is avoided.

We expect a mixed outlook with respect to peripheral bond markets in Europe. The recent compromise between Italy and the EU in relation to the 2019 fiscal deficit has allowed Italy to avoid sanctions from the EU and has enabled 10 year Italian spreads against Germany to narrow to 256bps. Despite the temporary respite, political uncertainties in Italy and questions over Italy's long term debt sustainability remain. As a result the expected range for Italian spreads over Germany in 2019 is expected to be 200/400bps with modest scope for further spread narrowing following the recent compression. We believe Spanish 10 year spreads against Germany which are currently 123bps reflect the better economic, fiscal and political backdrop in Spain and do offer scope for some further modest narrowing in the event of an avoidance of a recession or systemic risks to the EU and Eurozone. Overall, peripheral spreads are expected to remain sensitive to political developments across Europe, including the upcoming European elections in May 2019.

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